Supreme Court, U.S.
FILED
AUG 24 1999
OFFICE OF THE CLERK

No. 99-95

(3)

IN THE
Supreme Court of the United States

EXCEL COMMUNICATIONS, INC.,
EXCEL COMMUNICATIONS MARKETING, INC.,
AND EXCEL TELECOMMUNICATIONS, INC.,
Petitioners,

v.

AT&T CORP.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

A. The New Federal Circuit Standard For Patentable Processes Warrants Review

1. AT&T tries to deny the significance of the Federal Circuit's decision, claiming that "there is nothing new in the decision below." Opp. 16. Yet AT&T's own brief in opposition contradicts that claim. AT&T acknowledges that the Federal Circuit here adopted as a holding the *dicta* in *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 119 S. Ct. 851 (1999), which "set aside" the previously applied physical-transformation requirement incorporated in what was known as the *Freeman-Walter-Abele* test. Opp. 16. And AT&T acknowledges that the physical-transformation standard had, in fact, been applied to hold various claimed processes invalid under Section 101. *Id.*

In any event, AT&T's ostrich-like claim that there is nothing "evolutionary, much less . . . revolutionary" in the new Federal Circuit standard (Opp. 20) is patently incorrect. The Federal Circuit itself recognized that *State Street* had "reassessed" Section 101 standards (Pet. App. 9a), and took pains to note that the district court here, in invalidating AT&T's patent claims, did not have the benefit of State Street's new standard (*id.* at 12a). Moreover, it dismissed the previous decisions invalidating process claims under Section 101—not by distinguishing them under an unaltered standard, but by simply stating that they pre-dated *State Street*'s repudiation of the "physical limitations analysis" (*id.* at 15a-17a).

Thus, it is widely recognized that the Federal Circuit has abandoned the previously governing physical-transformation requirement and, in its place, has adopted a standard of mere practical usefulness that substantially guts the

"mathematical algorithm" limitation on patentable "processes." As one commentator summarized the matter, the *State Street* decision

> expanded the scope of patentable subject matter under patent law by *essentially eliminating* the method of doing business exception and *the mathematical algorithm exception to patentable subject matter* (at least in the context of machine claims). More recently, in *AT&T Corp. v. Excel Communications, Inc.*, the Federal Circuit clarified that the broad interpretation of statutory subject matter under 35 U.S.C. § 101 (patentable subject matter) provided in [*State Street*] is not limited to machine (e.g., "means for" apparatus claims), but also applies to process (e.g., software algorithm) claims.

Michael Schallop, "Federal Circuit Clarifies That Useful Software-Related Inventions Are Patentable Processes," 4 No. 3 Cyberspace Lawyer 2 (May 1999) (footnotes omitted; emphasis added); *see* Barton E. Showalter & Jeffery D. Baxter, *Strategic Use of Software Patents*, in 19th Annual Institute on Computer Law, 547 PLI/PAT 1057, 1061 (1999) (stating that "the Federal Circuit in [*State Street*] essentially dismantled the so-called 'mathematical algorithm' exception").[1]

2. Nor is there any doubt that the practical consequences of the new standard are as significant as the doctrinal change wrought by the court of appeals. AT&T, acting as if only all-or-nothing changes matter, notes the obvious fact that software patents were "applied for" prior to *State Street* (Opp. 19)—and even, of course, some-

[1] *See, e.g.*, John Dragseth, "Patenting Methods of Doing Business: After State Street and AT&T, It's the Law," 2 No. 12 Wallstreetlawyer.com: Sec. Elec. Age 18 (May 1999) (stating that "on April 14, the Federal Circuit issued another opinion, *AT&T v. Excel Communications*, which reaffirmed and extended the holding in State Street" (footnote omitted)).

times were issued by the PTO. But AT&T cannot dispute the evidence that there has already been a dramatic increase in software patent applications—as a "byproduct" of *State Street*'s expressly intended dropping of the legal barriers to patentability, according to the Acting PTO Commissioner. *See* Q. Todd Dickinson, "The State of the PTO," speech to ABA dated June 24, 1999, *partly reprinted in* Legal Times (Aug. 16, 1999) ("We projected that in 1999 the number of applications would increase 7.2 percent over 1998 numbers, but in the year to date, we are seeing 11.5 percent growth. . . . Much of the increase will be in computer-related inventions. . . . [W]e also expect many more applications claiming methods of doing business as a byproduct of the Federal Circuit's decision in *State Street Bank* . . . .").[2]

This increase can hardly be predicted to abate, as the Federal Circuit's new standard necessarily encourages the filing of even more patent applications and lawsuits, not only because companies will seek to acquire a newly available competitive weapon, but because they must act defensively to protect themselves from others seeking to acquire and enforce patent rights against them.[3] Accord-

[2] *See, e.g.*, "In the News," 4 Cyberspace Law. 16 (May 1999) ("The floodgates [of patents] really opened after the Federal Circuit's decision in State Street Bank & Trust . . . ."); Showalter & Baxter, 547 PLI/Pat 1057, at 1065 (stating that "*State Street* likely signals the beginning of a modern-day gold rush as software developers clamor for patent protection to secure important market positions"); Carey R. Ramos & David S. Berlin, *Three Ways To Protect Computer Software*, 16 COMPUTER LAWYER 16, at *16 (1999) (describing current "madcap race among [software] developers to file as many patents as possible"); Paul Beck, *State Street Bank Case Causes Shock Waves in Banking and Financial Industry*, 147-JAN PITTSBURGH LEGAL J. 7, 7 (1998).

[3] A recent report from Silicon Valley quoted a venture capitalist: "'None of my companies seek patent protection because they actually think it will protect them from competition,' says David Cowan . . . . 'Rather, they seek patents to protect themselves from

ing to a recent observer reporting on the sharp increase in patent activity just in the computer software industry, it is the new legal standard first announced in *State Street* that "has ushered in the new wave of patent litigation—and pre-emptive armament," and that standard "has had wide repercussions in Silicon Valley, prompting valley companies to defend even mundane Internet software." Scott Herhold, *supra*. *See also* William T. Ellis and Aaron C. Chatterjee, "Shakeout on *State Street*: A seismic Federal Circuit precedent makes patents a potent financial services weapon," *IP Magazine* (Nov. 1998) (describing *State Street* as "one of the most important decisions relating to patentability of software—a decision that strongly suggests an immediate re-evaluation of the intellectual property strategy of every major company in the banking, insurance and financial industries").

In short, AT&T cannot deny the evident significance of the real-world "sea-change" effected by the Federal Circuit. Nor does it even try to address the policy questions —not addressed by Congress—that attend such an expansion of patent protection to previously unpatentable processes for manipulating data by mathematical operations. In particular, AT&T does not deny that the result is to saddle the PTO with applications that are especially likely to be issued erroneously, because prior art that exists is hard to find. The change in the governing legal standards, and the practical consequences of this change, are unmistakable.

3. Just as AT&T is wrong in trying to deny the fact and significance of the Federal Circuit's transformation of

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other people who have patents. It's a form of protection that frankly, I wish we didn't have.'" Scott Herhold, "Patent War Pending: Once-Arcane Field Emerges as Battleground Between Online Start-Ups and Established Companies," San Jose Mercury News (July 18, 1999). *See id.* ("In general, . . . Silicon Valley companies insist they're only playing defense.").

its own precedents—which have governed this area since this Court last addressed the matter almost 20 years ago, *see Diamond v. Diehr*, 450 U.S. 175 (1981); *Parker v. Flook*, 437 U.S. 584 (1978); *Gottschalk v. Benson*, 409 U.S. 63 (1972)—AT&T is wrong to suggest that this Court in *Diehr* already effected the elimination of the physical-transformation requirement, and substituted mere usefulness as a sufficient condition, which the Federal Circuit announced in *State Street* and adopted in the present case. Opp. 13-15. That suggestion is almost incomprehensible. It flies in the face of the undeniable fact that the physicial-transformation requirement, and the recognized insufficiency of mere limitation to a practical use, were part of the understanding of the Federal Circuit and its predecessors regarding *Diehr* for the two decades preceding *State Street* and this case.

In any event, the petition clearly sets out the reasons that *Diehr* cannot now be read as AT&T wishes. Nothing in *Diehr* repudiates the earlier holdings of *Benson* and *Flook*. The *Diehr* Court had no occasion to repudiate the physical-transformation requirement, as the case involved an undeniable process of physical transformation (changing the chemical state of rubber by curing). Indeed, the Court expressly relied on the centrality of the longstanding physical-transformation requirement in answering the crucial question of how one tells whether the line separating protectable from unprotectable processes has been crossed by a patentee's claim. 450 U.S. at 183-84 (quoting decision in *Cochrane v. Deener*, 94 U.S. 780, 787-88 (1877), and ruling of *Benson*, 409 U.S. at 70, that physical transformation is "'the clue to the patentability of a process claim'"). The Court likewise expressly reiterated the *Flook* holding that merely "limiting the reach" of a mathematical operation "to a particular technological use" is not enough to bring the mathematical manipulation of

data within Section 101. 450 U.S. at 192 n.14. These are the very principles that the Federal Circuit has now disclaimed in collapsing the question of statutory subject matter into the distinct question of usefulness.[4]

Not surprisingly, then, it has been well recognized that *Diehr* itself preserved, rather than rejected, the requirement of a physical transformation to identify patentable processes. *See In re Schrader*, 22 F.3d 290, 295 (Fed. Cir. 1994) (noting that the "requirement that in a process claim compliance with § 101 requires some kind of transformation" is "cited with approval in *Diehr*"); *see also* Claus Melarti, *State Street Bank & Trust Co. v. Signature Financial Group, Inc.: Ought The Mathematical Algorithm And Business Method Exceptions Return To Business As Usual?*, 6 J. INTELL. PROP. L. 359, 368 (1999) (stating that "*Diamond* [*v. Diehr*] made clear that the physical transformation alluded to in *Gottschalk* [*v. Benson*] and *Parker* [*v. Flook*] was a prerequisite to such kinds of patent protection. Consequently, all software patents utilizing mathematical algorithms must satisfy this 'transformation inquiry' "); Wesley L. Austin, *Software Patents*, 7 TEX. INTELL. PROP. L.J. 225, 238 (1999) ("*Diehr* teaches that transformation and reduction of an

[4] Although AT&T pretends otherwise (Opp. 18), the appearance of "useful"—like the appearance of "new"—in Section 101 has never justified treating utility as a sufficient condition for a process (or apparatus, etc.) to be statutory subject matter. "Section 101 *states* three different requirements for patentability: novelty, utility and statutory subject matter. The understanding that these three requirements are *separate* and *distinct* is long-standing and has been universally accepted. . . . [T]he questions of whether a particular invention is *novel* or *useful* are questions wholly apart from whether the invention falls into a category of *statutory subject matter*." *In re Bergy*, 596 F.2d 952, 960 (C.C.P.A. 1979) (emphasis own); *see Flook*, 437 U.S. at 588 (assuming for purposes of Section 101 analysis that the invention "is novel and useful," but ultimately concluding that claims describe subject matter not eligible for patent protection).

article to a different state or thing is the clue to the patentability of a method claim."). Only by a deliberate act amounting to a declaration that this Court's precedents are outmoded could the Federal Circuit adopt its new standard. *Cf.* Michael Schallop, *supra* (gently characterizing the treatment of *Diehr* by the panel in the present case: "This interpretation is clearly broader than the holding or dicta of the Supreme Court's decision in *Diehr* . . . ."). As the petition explains, such disregard for this Court's precedents is impermissible and itself warrants review.

B. This Case Is A Good Vehicle For Review Of The Important Issue Raised In The Petition

AT&T does not deny that, although the Federal Circuit in *State Street* made the suggestion in *dicta* (because that case involved a machine claim),[5] this is the case in which the Federal Circuit definitively adopted, as governing precedent, the new anemic standard for patentability of processes under Section 101. *See* Michael Schallop, *supra*; Debra Freeman & Gabriel Meister, *Selected Intellectual Property Law Developments*, 4 ELEC. BANKING L. & COM. REP. 20 (May 1999) (*AT&T v. Excel* "followed and expanded upon the [Federal Circuit's] reasoning in *State Street*"). Because the law is now established in the Federal Circuit (*see* John Dragseth, *supra* ("with the two opinions representing the votes of five judges of the eleven-judge court, it is unlikely the law will change anytime soon")), this is the natural case for reviewing this important issue. Nevertheless, AT&T suggests that this is not a good vehicle for review because, AT&T says, the result would be the same under a different rationale (the physi-

[5] The court of appeals has recently confirmed that the claims at issue in *State Street* "claimed a machine" that was "made up of, at the very least, the specific structures disclosed in the written description and corresponding to the means-plus-function elements . . . recited in the claim." *WMS Gaming Inc. v. International Game Technology*, 51 U.S.P.Q.2d 1385, 1391 n.4 (Fed. Cir. 1999).

cal-transformation standard) from the one applied by the Federal Circuit, and Excel may yet prevail in invalidating the patent on some ground other than lack of patentable subject matter under Section 101. Opp. 21. Neither objection has any merit.

1. AT&T's argument that it would prevail under the physical-transformation standard (Opp. 21-22) provides no ground for this Court to avoid review of the Federal Circuit's express ground of decision. It is the expressed rationale that establishes the law of the Federal Circuit on the important issue presented. *See Matsushita Elec. Indus. Co., Ltd. v. Epstein*, 516 U.S. 367, 379 n.5 (1996) ("While it is true that a respondent may defend a judgment on alternative grounds, we generally do not address arguments that were not the basis for the decision below. See *Peralta v. Heights Medical Center, Inc.*, 485 U.S. 80, 86 (1988)."); *Carlucci v. Doe*, 488 U.S. 93, 104 n.6 (1988). Rather, the ordinary and proper course is to review the new announced standard of law and (as Excel contends) to articulate a corrected standard, then either apply the corrected standard or remand for application. *See, e.g., Kumho Tire Co., Ltd. v. Carmichael*, 119 S. Ct. 1167, 1176-79 (1999) (directly applying corrected standard (of appellate review) to case); *United States v. Lanier*, 520 U.S. 259, 272 (1997) (correcting legal standard and remanding "for application of the proper standard."); *Strickland v. Washington*, 466 U.S. 668, 698 (1984) (directly applying new standard).

In fact, the Federal Circuit's adoption of a new legal standard to replace the physical-transformation standard was hardly inadvertent or inconsequential for this case. AT&T not only made but stressed the argument that it would prevail under the physical-transformation standard in the court of appeals, yet the court pointedly refused to adopt AT&T's argument for reversal of the district court on this basis (even in the alternative). In responding to

Excel's specific argument that AT&T's patent failed under the physical-transformation standard, the Federal Circuit did not disagree, but instead rejected the "argument that physical limitations are necessary." Pet. App. 15a.

The court's refusal to endorse AT&T's argument reflects the strain of AT&T's effort at trying to pour its actual claims for data manipulation and recording into a physical-transformation mold. Reading the claims carefully, the court of appeals and the district court expressly recognized that the claimed method implements a fundamental mathematical operation. Pet. App. 12a-13a, 32a. The two lower courts also agreed that the claims do not recite processes for transforming a long-distance call (as AT&T bizarrely says, Opp. 7), or for generating an electronic message record *per se* (which itself constitutes nothing more than a format for arranging pieces of information), but instead claims a process of deriving a specific piece of data from other data (referred to in the patent as a "PIC indicator") and including it as an entry in an industry-standard message record generated for long-distance telephone calls. Pet. App. 4a, 24a. This process of data manipulation, though ancillary to a telephone call, no more satisfies the physical-transformation requirement than did the process of data manipulation (calculating an "alarm limit"), ancillary to an expressly recited process of catalytic conversion, held invalid in *Flook*. 437 U.S. at 594-95, 597-98. Thus, the crucial disagreement between the district court and court of appeals in this case—and the dispositive issue under Section 101—is the proper legal standard to be applied to the claims. The Federal Circuit's express rationale adopting a new legal standard is properly reviewed in this case.

2. AT&T's suggestion that this Court should pass over the important legal issue presented in Excel's petition because of its "interlocutory" nature (Opp. 22) is likewise

meritless, for multiple reasons. The Federal Circuit's ruling, if reversed, would end this case on a clean legal ground: invalidity of the patent claims for lack of patentable subject matter. In such circumstances, this Court has often granted review of dispositive legal issues notwithstanding the potential that other issues in a case might, through further proceedings, eventually result in a judgment for the petitioner on a different ground. *See, e.g., Harbor Tug and Barge Co. v. Papai*, 520 U.S. 548 (1997); *Yamaha Motor Corp. v. Calhoun*, 516 U.S. 199 (1996); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

Moreover, there is essentially no chance that this Court's consideration of the dispositive legal issue of Section 101 validity would become moot. First, although AT&T neglects to mention it, the district court, aware of this petition, has already indicated to the parties that in view of the dispositive nature of the Section 101 issue, it would seriously consider staying further proceedings in this case if the Court grants review. Second, even if a trial were to be held in November, the Section 101 issue would not become moot before its decision by this Court, which would occur, in the ordinary course, by June 2000 if review were granted at the start of the 1999 Term. Unless AT&T were to lose on validity at trial and, in addition, decide not to pursue post-trial motions and appellate review, the case—and, indeed, the validity of AT&T's patent—would still be open and alive upon decision of the Section 101 issue by this Court. Accordingly, this case is a good vehicle for review of the important question of patent law presented by the petition.

CONCLUSION

For the foregoing reasons, and the reasons set forth previously, the petition for a writ of certiorari should be granted.

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August 24, 1999